GLOBAL EQUITIES OUTLOOK

By Clint Dove & Charles Marché

The stars are aligned for good gains in developed world equities in 2021, with potential appreciation of up to 20% from current levels, according to FAB's calculations. Equities are not expensively valued relative to where interest rates are, and are expected to remain for a few years to come.

A rising tide will lift most boats, with the US providing the main impetus. Apart from some unexpected bad news related to Covid-19, the main risk ahead for investors is that of a 'melt-up', with risk asset prices increasing too fast. That is what usually happens in the final stage of a normal bull market. Perhaps above all, investors should plan to be invested, and stay invested, throughout 2021.

This year, individual investors in equities will increasingly have the world's pension and sovereign wealth funds on their side, as these institutional investors increase the proportion of equities in their portfolios to maximise total returns amid low bond yields. Dividends tend to grow over time, whereas coupons do not.

Such low rates, however, lead to higher equity valuations. It is difficult to measure the weight of money that could come out of bonds and cash, and move into equities, although it could be substantial.

Besides, historically, there is cash sitting on the sidelines in the final third or so of a bull market, as many investors tend to sell too soon. Many of these should

eventually capitulate, driving the market to an extreme peak.

These factors suggest the global equity bull market will accelerate in 2021, following the aberration of 2020, which was a 'flash' bear market, and investors should consider having full exposure to the asset class.

Some investors may be scarred by the crash in March, and that would be understandable. From 19 February to the low of 23 March, liquidity seized up and risk asset prices plummeted. However, even before that event, investors were increasingly worried about the onset of the next cyclical recession. After the 'flash' recession, and despite the serious winter wave of infections, the next cyclical recession is probably several years away.

Information Technology was the best performer last year, up 37.4% by mid-December for the year to date, followed by Consumer Discretionary (31.2%), then Communication Services (22.6%), while the worst was Energy (-26.7%), followed by Real Estate (-6.2%), and Financials (-5.2%). 'Value' as a style made a comeback in the closing months of 2020, after underperformance stretching over some years. Accordingly, it became fashionable to pan 'Growth' as a spent and overvalued style. However, a common-sense approach for 2021 is to allocate selectively between these two styles.

Last August, the Fed reiterated that it would tolerate inflation (their measure is the PCE 'core' deflator) moving above 2% for a period, making it clear that the Fed funds rate would remain close to zero for at least a few years. Core inflation was 1.4%, annualised at the end of September. With the massive ballooning of the balance sheets of the biggest central banks, it would be financially suicidal to reverse easy monetary conditions anytime soon.

This is far from a normal cycle and the Fed is tasked with restoring full employment, aside from trying to drive inflation up. The US dollar has been debased but FAB's house view is that this has further to go.

With the yield on three-month Treasury Bills at 0.07%, real interest rates were minus 1.3% in December, or close to that, depending on how you measure it. That is very bullish for US stocks, as it magnifies the present value of future earnings in the immediate years to come.

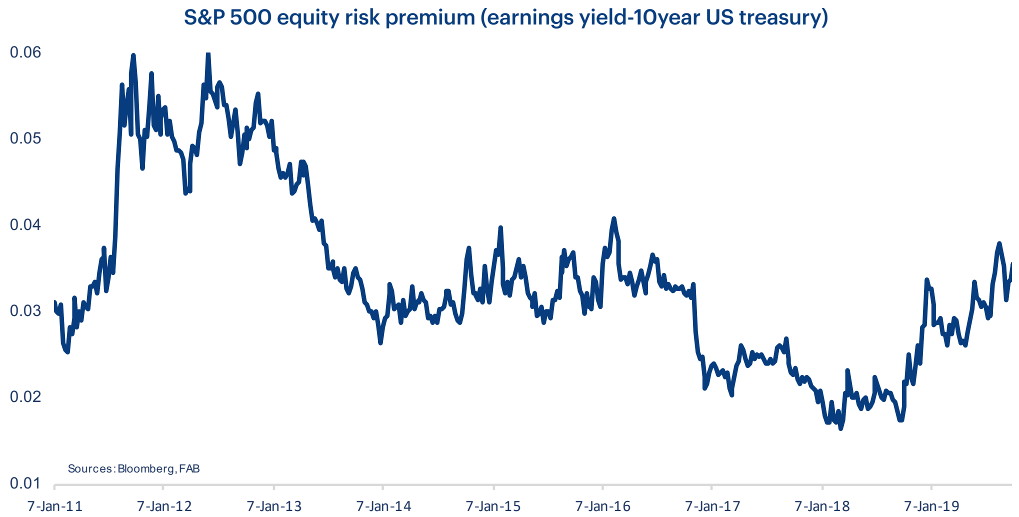
The IMF currently expects GDP growth of 3.9% in advanced economies in 2021 (compared to a 5.8% contraction in 2020), and 6% in developing economies, after a 3.3% recession last year. These numbers could be revised upwards during the Northern Hemisphere spring.

By the same token, analysts' estimates of corporate earnings are likely to continue to improve. They were too pessimistic throughout 2020. Since the end of June 2020, forecast earnings for the MSCI World have been trending upwards, and this should continue into the second half of 2021. This would be bullish for global equities.

Some other global metrics are also supportive. The J.P. Morgan Global Composite Purchasing Managers Index (PMI) was standing at 52.1 and rising when the pandemic hit, and eleven months later it stands at 53.1, above the pre-crisis level and in expansion mode. The Citi Global Economic Surprises Index hit an extreme low of -79.1 on 30 April last year, but has since rallied to 83.5 and remains in an uptrend, so economic forecasts are being broadly exceeded. Finally, five-year US inflation expectations have increased to 1.85% as per break-even data, and this is fine, if correct, as it signifies almost ideal reflation, allowing companies to exercise moderate pricing power, affordable for the majority of consumers.

In mid-December, the S&P 500 Index was at 3,647 and was trading on a prospective P/E ratio of 21.2x for 2021, and 18.3x for 2022, based on earnings growth forecasts of 21.9% and 15.7% respectively. The Bloomberg consensus is for average earnings of US$172.15 per share of the index for 2021, and US$199.16 in 2022.

Analysts have gradually been revising earnings up for both years, and we expect this to continue. Going into the second half of 2021, investors will increasingly be using prospective 2022 earnings, the estimate for which could easily edge further upwards, to perhaps US$210, for a 2022 P/E of 17.4x, equivalent to an earnings yield of close to 5.75%.



Provided the Fed prevents the ten-year Treasury yield from rising above about 1.3%, the S&P 500 could trade up to circa 21x earnings (or just above 4,400), for further upside of 20% from current levels. Why 21x, rather than 18x earnings? Because the market was already trading at 21.1x for 2021 in December, and such a multiple should be facilitated by continued negative real interest rates.

This is an equity bull market, and an equity risk premium in the region of 4.5 percentage points (vs. about 3.80 in December for 2021) would be attractive.

The weights of the MSCI World Index (which, despite the name, includes only developed markets) were as follows in December: US (55.36%), Japan (6.81%), Europe ex-UK (8.18%), China (4.71%), and the UK (3.76%). Emerging markets constitute just over 13% of global equities, and make up the MSCI Emerging Markets Index, of which China is by the far the largest part (about 38.5%). In the future, investors will have to understand Chinese equities much better and make larger allocations to the class than they currently do.

The STOXX Europe 600 Index was trading at 392.40 in mid-December, at a prospective P/E of 17.1x earnings for 2021, and 14.7x for 2022, based on earnings growth expectations of 36% and 16.4% respectively for those years.

European stocks traded at 1.77x estimated book value for 2021 in December, compared to 3.62x for the S&P 500, on the face of it implying an asset price discount across the Atlantic – however the forecast return on average equity is only 10.58% for European stocks, compared to 17.65% for the S&P 500.

Global investors have long been disappointed by European stock markets, and the political tilt of the Eurozone and its structural issues are perpetuating this, even if the index's 'value' emphasis leads to sporadic upside. Further strength in the euro would hurt exports, and foreign earnings upon translation, the exact reverse of what is expected in the US.

The Japanese TOPIX Index was trading at 1,782 in mid-December, on a prospective P/E of 16.2x consensus earnings for the year ending March, 2022, and 14.0x for the year ending March, 2023, based on earnings growth of 43% and 15.7% for those years respectively. The index was trading at only 1.24x book value for the year ending March, 2022, but its return on average equity was just 7.84%, compared to 17.65% for the S&P, and that is after substantial anticipated earnings growth in Japan.

The FAB Asset Allocation Committee in the fourth quarter of 2020 went tactically overweight in Japanese equities, recognising a technical breakout in the Nikkei 225 Index, plus the probability of a good 'value' trade at that time. The BoJ has been actively buying Japanese equities as part of its QE in recent years.

Ultimately, as stated at the beginning, all boats are likely to be lifted this year.